DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

36 Letters per Year — $75 Annually

Registered with the Securities Exchange Commission

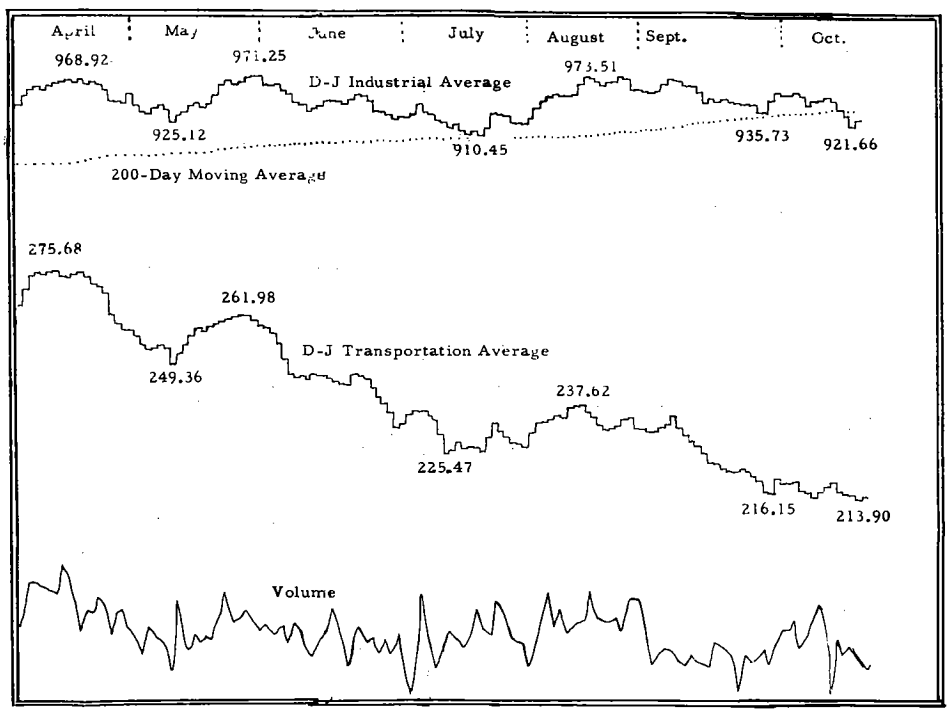
October 20, 1972 Letter 544

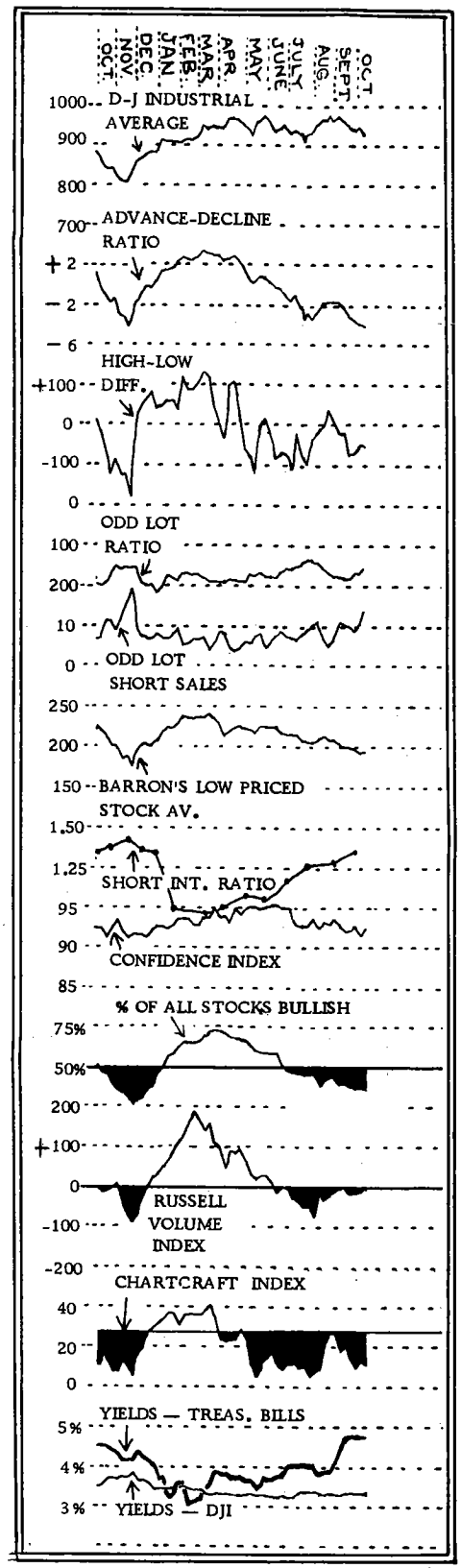
Oct. 6 Dow 945.36, PTI 920, A-D ratio -3.99
Oct. 13 Dow 930.46, PTI 910, A-D ratio -4.52

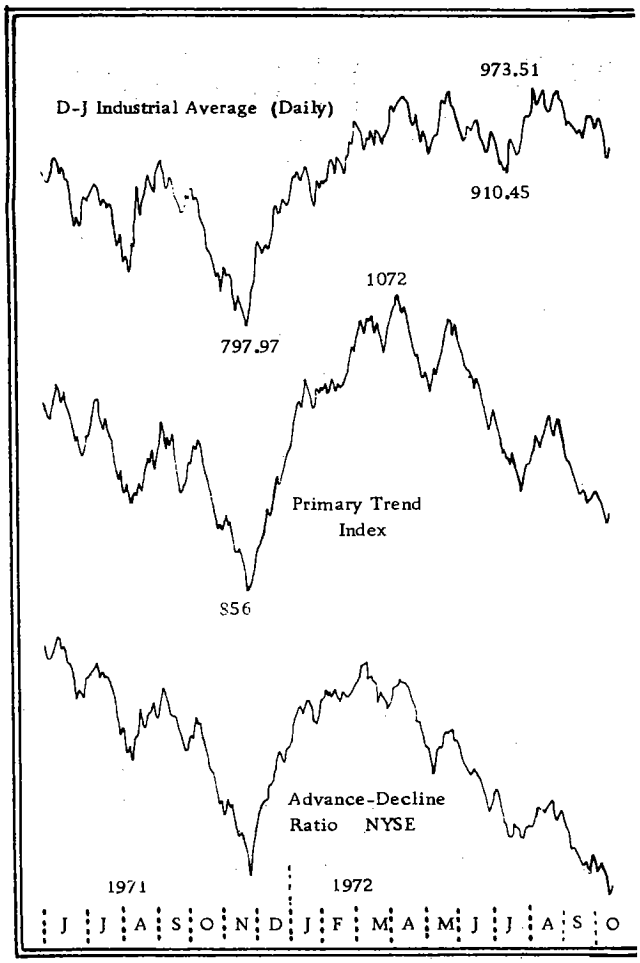
THE MARKET: Earlier this year I began calling attention to the very poor performance of the advance-decline ratio and the gathering series of divergences between price (the Dow) and breadth (the A-D ratio). No one took this very seriously, since the major question at that time seemed to be "what week or month the Dow would climb over the 1,000 mark." In Letter 531 I presented a careful analysis of breadth, comparing the price-breadth relationship of 1971-72 with that of 1965-66. My conclusion was the situation in 1971-72 was worse, and "...as poor as I have ever seen it." I must admit that my bearish observations caused no great uproar on Wall Street at the time.

During the past few months, however, the meaning of a collapse in the A-D ratio has been made painfully clear to investors and speculators. With the wiping out of all the A-D ratio gains of 1972, and with last week's breaking of the 1971 low on the breadth index, stockholders are counting their losses. The fact is that the dramatic and powerful price-breadth divergences which I wrote about in previous Letters indicate that the majority of stocks on the NYSE have been under heavy distribution. All the while, the Dow Industrial Average has kept alive the illusion that "the magic rally to 1,000 is just around the corner." And around the corner it may be, but the continuing collapse in the advance-decline ratio suggests that the average stockholder may go broke even if the Dow finally succeeds in hurdling the 1,000 level.

Behind all this agony, of course, lies meaning and logic. And it seems to me that what the market is saying is that the vast majority of stocks are going to face some very difficult and nerve-wracking times during 1973 and 1974. For the same powerful forces which are pushing prices down are in reality forces which are protecting themselves, forces which are swapping stocks for cash, and forces which are not willing to carry their corporate certificates into 1973 in view of the problems which they see ahead. So it seems to be a case of the tape versus the Administration and the propaganda and the optimists. So far, the tape is the winner.







At certain junctures my "seat-of-the-pants" intuition tells me that the market is moving into a dramatic area. At such times, I find myself making mental notes of significant events, and this time I thought it would be interesting to get my technical "notes" down on paper. Here are some of the more important of these notes:

Sept. 25 & 26. . . Industrial and Transport Average record lows in their decline from the August peaks. Industrial low is 935.73, Transports low is 216.15. A little rally follows.

Oct. 4. . . Transports break below their Sept. 26 decline point and establish a new low for the year. Industrials fail to confirm and are holding above 935.73.

Oct. 5. . . Dow breaks its short-term trendline on the point & figure chart, indicating increasing weakness (see chart page 3).

Oct. 5. . . Primary Trend Index (PTI) penetrates its September 26 low, dropping to a new low for the year (page 2 chart).

Oct. 5. . . Daily new lows on the NYSE climb to 101, highest figure since the 107 of Sept. 12.

Oct. 5. . . A dramatic plunge in which the advance-decline ratio violates its November, 1971, low, sinking to its lowest level since August, 1970 (at which time the Dow was in the mid-700's).

Oct. 11. . . "Most-active stocks" index drops back into the negative area, after being positive for 8 consecutive days. (This index is constructed by tabulating the plurality of the 15 most active stocks each day, then putting those pluralities on an 8-day moving average (see description in Letter 524).

Oct. 10. . . PTI rallies above its minor late-September peak; Dow refuses to confirm. This is strange since the Dow has "looked" so strong or at least has been resistant to decline. If the Dow is so "strong," why won't it rally here? To me, it's an indication that the strength in the Dow is ebbing. And the Dow is the last pocket of strength in this market.

Oct. 11. . . IBM, the bellwether stock of the market (although I still watch GM carefully) gives a point & figure "sell signal" by touching 392 (see chart on page 3). Volume in IBM today is a whopping 102,300 shares, three times its "normal" volume. On-balance-volume for IBM has been plunging (see later section of this Letter for description of on-balance-volume). Something is drastically "wrong" with IBM.

Oct. 12. . . I had drawn trendlines on the Dow Industrials and on the A-D Index for the 30 Dow Industrials, these trendlines connect the July and September bottoms. Today both trendlines are violated, indicating further weakness in the Dow Industrial Average (see Letter 532 for description of Dow A-D index).

Oct. 12. . . The 4-week moving average of the Dow Industrials drops to 943, thereby breaking below the 13-week moving average of the Dow, which stands at 946. This gives a #1 or "preliminary sell signal" as outlined in previous Letters (see Letter 533).

Oct. 13. . . Dow Industrials decline, touching an hourly 930 (at 12PM). This provides a second and more important "sell signal" on the point & figure chart (the first sell signal came at 950, see chart on page 3).

Oct. 13. . . A-D ratio and PTI both break to new 1972 lows. Dow drops below its Sept. low of 935.73, thereby confirming earlier weakness of Transports. GM sells off sharply, "presumably" on news of a strike. Everyone saying the market is "oversold" as well it might be, but this is a highly dangerous market and the "in-and-out" traders are welcome to try to guess at the turns.

Oct. 13. . . DJI drops below its own 200-day moving average which stands at 938.

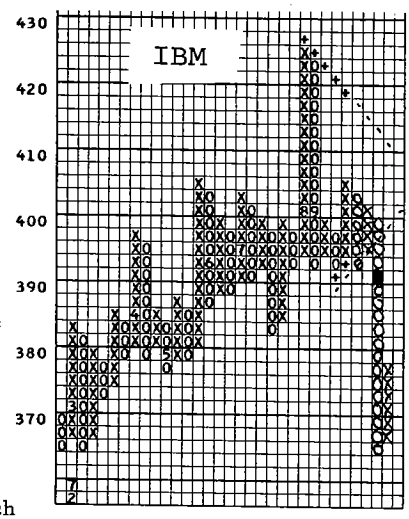
Oct. 16. . . (Monday) Market hit badly, Industrials break to 921.66, lowest since July, Transports sink to new low for the year, PTI and A-D ratio both drop to new 1972 lows. All around "in gear" weakness. Critical point now is the July 20, 1972, Industrial low of 910.45. IBM broke over 14 points today. Daily new lows on NYSE rise to 102.

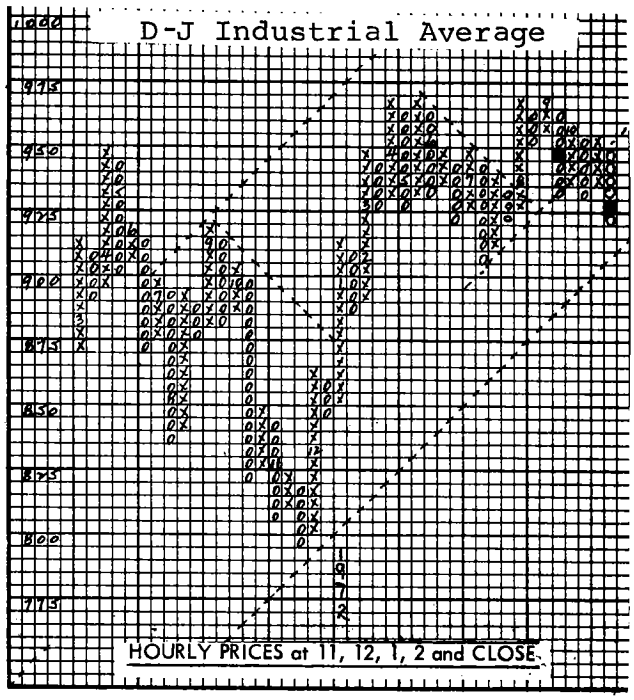
Oct. 17. . . Market rallies, Transports very sluggish, new lows (oddly) increase to 113. Rally hardly impressive, but you can never tell by one day's action.

Oct. 18. . . Market rallies second day amid "umpteenth" peace rumor. But market has been down for weeks and is certainly ready to rally. Agnew could give the peace sign at a hippie convention and the market would rally. It is "tired" of eroding.

I realize that new readers and many veteran readers may have some trouble in following all the items listed above. For this reason I consider it vital for subscribers to save and file back issues for these reports. It is your time, your effort, your money, your savings, and these Letters are written so that you should be able to understand and use the various tools and thoughts which

appear here. Personally, I would not read a report unless the writer discloses what he is doing, how he thinks, and the nature of the tools he uses. I want subscribers to be familiar with my thinking and my market tools.





POINT & FIGURE: Here are two P & F charts (courtesy of Chartcraft, Larchmont, NY 10538). The chart of the Dow is constructed as a 5-point, 15-point reversal chart. This means that each box represents 5 points on the Dow, and that only reversals and subsequent moves of 15 points or more are shown. The vertical columns of X's indicate rallies of 15 or more points. The rows of O's represent declines of 15 or more points.

The first "sell signal" is identified by the solid black box at the 950 level. Here the Dow broke below the preceding column of O's. Following this signal, the Dow declined to 935, rallied back to 955, and then declined to 930 (the 930 box is also filled in solid black, and this identifies a second sell signal).

Note that the latest move down to 930 and below broke below three preceding boxes of O's, the O's all being at 935. This formation of three O's is termed a "triple bottom," and the penetration of such a triple bottom is considered a very reliable bearish signal.

The next possible bearish development to watch for would be a decline by the Dow to 905. If this occurs, (1) it would break the July, 1972, low of 910 on the Dow (see chart), which is the last resistance level between here and the 1971 low of 797, (2) it would penetrate the ascending trendline which is drawn from the 1971 bottom as shown on the chart. In other words, any decline which takes the Dow to an hourly reading of 905 or less would be undeniably long-term bearish according to P & F analysis.

The second chart shows IBM and this is a 2-point, 6-point reversal chart. Here we see the bearish signal as 392 is touched (black box), and the subsequent weak action. Thus, the major bellwether stock of the market and an institutional favorite has turned bearish. On Oct. 16, reacting to a Justice Dept. suit, IBM dropped 14 points, a bad omen for the entire market.

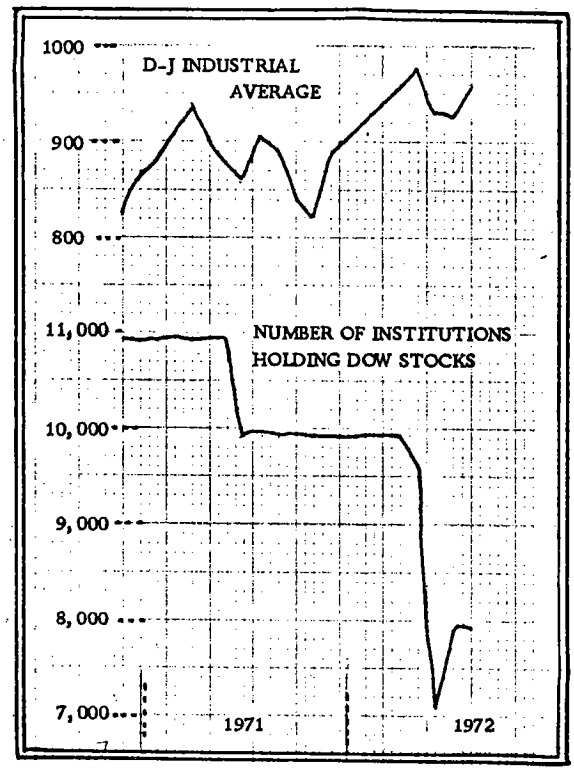
INSTITUTIONS TO THE EXITS: In the last report I mentioned that Investment Quality Trends (5453 La Jolla Blvd., La Jolla, CA 92037) had done some original research on institutional holdings of 350 blue-chip stocks, stocks which IQ Trends monitors very carefully. IQ's findings were that since the June, 1972, quarter, there has been a surprising drop in the number of institutions which hold these 350 high-grade stocks. Actually, there was a drop from 43,548 institutions to 36,160, a decline of 20%! This I found most remarkable.

I suggested to IQ Trends that they use their records to check back on the institutional holdings in the 30 Dow stocks, and they agreed that this would be a worthwhile project. A few days ago they sent me a listing of the number of institutions which hold the 30 Dow stocks, with postings monthly going back to December, 1970. The results were amazing.

On December, 1970, 10,850 institutions held shares in one or more Dow Industrial stocks. By June, 1972, the number of institutions had dropped to 7,170, a loss of 33%. Over the past few months there has been a slight rise in the number of institutions holding Dow stocks, but not enough to materially alter the conclusions.

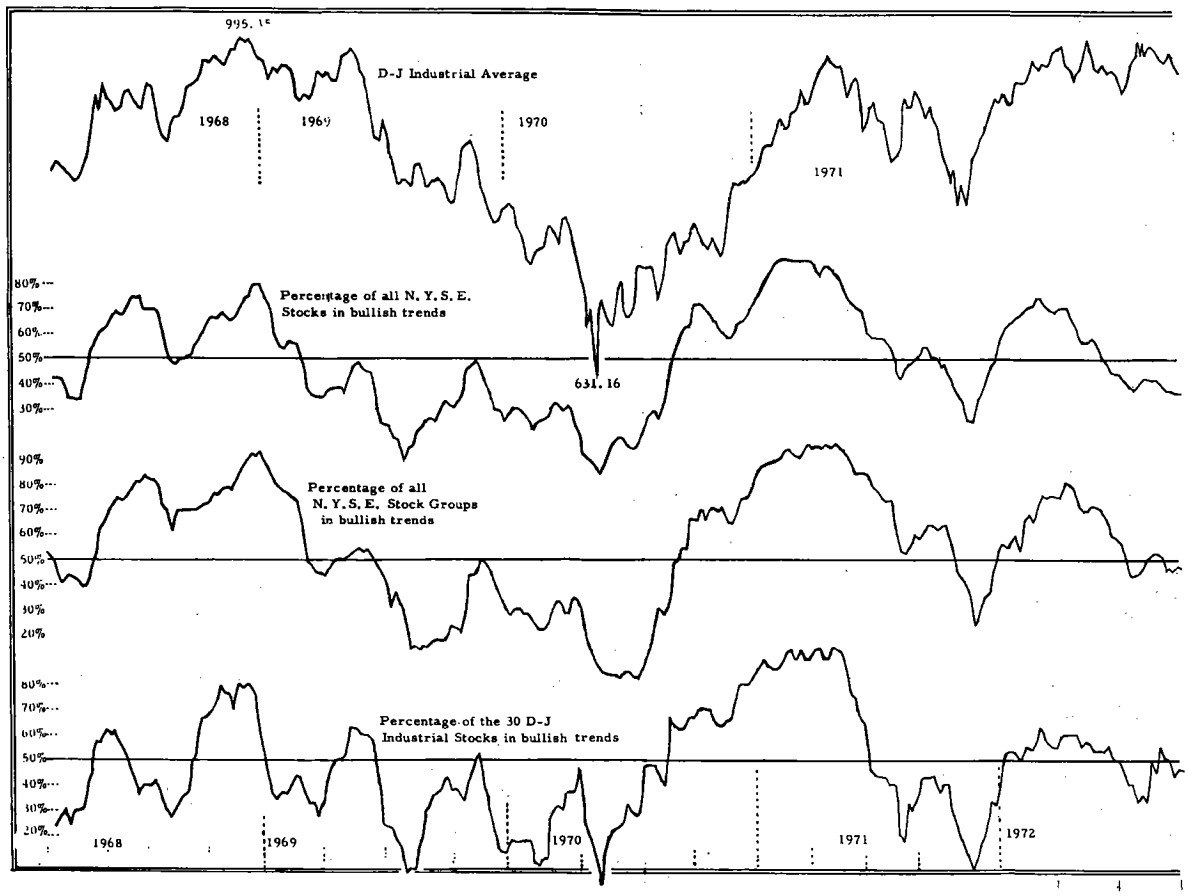
Remember, these figures deal with institutions which have eliminated, not reduced, holdings in Dow stocks. The implication is not they are playing it "a little more conservatively," no, they want "out."

From another standpoint, these institutional figures are interesting. Here are the four biggest percentage drops in institutional holdings of individual shares (from December, 1970, to the present): American Can down 55%, Anaconda down 52%, General Foods down 41% and Owens-Illinois Glass down 38%. During that period AC dropped from a high of 46 to a low of 27, Anaconda dropped from 66 to 11½, General Foods fell from a high of 45 to a low of 23½, and OI went from 66 to 41. It would seem that when institutions move out of a stock, the odds are that the stock is heading down.



We do not have records of any major build-ups in institutional holdings (we only go back to December, 1970), but I would guess that major accumulations by institutions of given shares would represent a definite plus as far as the stock's performance over the future.

I have drawn a chart showing the path of the Dow Industrial since December, 1971, and the number of institutions holding one or more Dow stocks. The extraordinary factor here is that although there has been a massive drop in institutional holdings, the Dow Average itself is now roughly in the same range it was at the early 1971 (April) peak. What does this mean? Will the Dow as a whole go the way of the individual stocks which have lost major portions of their institutional support? I have a feeling they will, and I say this taking account of the thesis that this is a primary bear market, a bear market which has been in effect since February, 1966.



BULLISH PERCENTAGE: One of the best gauges of the internal strength of the market is the chart of bullish percentages. Here we see the weekly closing of the D-J Industrial Average, while below the Average are three lines: (1) the percentage of all stocks on the NYSE which are in bullish trends, (2) the percentage of all NYSE groups in bullish trends, and (3) the percentage of the 30 Dow stocks in bullish trends. (All tabulations are from Chartcraft, Larchmont, NY 10538).

In all cases, the 50% or halfway level represents the critical level in bullish percentage analysis. It is as though the 50% level represents the fulcrum of the see-saw, and if the index rises above 50% (particularly when confirmed by the other indicators)

the trend or momentum is up (the converse, of course, is true when the indices drop below 50%).

What is important to note here is the action at previous tops such as late-1968, early-1971, and early-1972. In each of these cases a certain amount of technical strength was apparent in that all three bullish percentage lines pushed well over the 50% level. It is interesting to note the warnings, however, at the subsequent Dow run-ups of early-1969, and early-1971. In both cases, the bullish indices acted very sluggishly, indicating that market strength was ebbing. These warnings were followed by substantial declines in the general market.

Now, turning to the current year 1972 we see that at the May peak of 971.25 all three of the indices were well above the 50% level, even though the warning was clear in that they were dropping off as the Dow hit its high.

But at the August "double top" of 973.51 we see the bullish percentage of all NYSE issues actually below 50%, a dramatic decline in broad market strength, despite the cover-up performance of the Dow. At the same time we can see that the bullish percentage of all groups and the bullish percentage of the 30 Dow stocks pushed temporarily above the 50% level, then turned down again.

All in all, I consider the performance of the three bullish percentage indices quite bearish in that they offer little or no support for the Dow on its rise to the August peaks of 973.51.

Since August the all-stock bullish percentage line has sunk to the 36% area, the all-group bullish percentage has declined to 45%, and the Dow bullish percentage, having dropped to as low as 33%, is currently at the 47% level. In studying the recent action of the chart, it appears to me as if the three indices tried to move up through the 50% level, lost momentum (the all-stock bullish percentage failed to rally above 50% at all), and then turned down. This same type of action occurred in the second quarter of 1969, just before the market momentum turned violently down. It is possible that we are at that same kind of juncture today.

STOCKS: In Letter 540 I mentioned that I was working on some exciting new charts with which I hoped we could identify the strongest and the weakest of the Dow stocks. The reason for this effort is clear enough. When the Dow Industrial Average advances (and this really pertains to intermediate and major or primary movements), certain Dow stocks are obviously going to undergo important and profitable movements. The exact converse is true when the Industrials decline, in that certain of the Dow stocks are going to embark on important declines. The question: How we can identify the most likely candidates to advance or decline?

First, the easiest and most reliable way to classify strength (or weakness) in stocks is through relative strength. Is the stock acting better or worse than the market? Relative strength should not be confused with bullish or bearish trends. If the market is collapsing, a stock may merely be declining gradually. Since it is going down it is probably in a bearish trend. Since it is going down less rapidly than the market, it's relative strength line is rising (and it is showing a certain kind of strength in that it is outperforming the market). Such stocks are likely to lead on the next general market rally.

I am indebted to Ray * Signals (43 Lake Ave., Montrose, PA 18801) for relative strength (RS) data. The most recent changes in RS in Dow stocks are as follows: RS bullish are Amer. Telephone, Int. Nickel, Standard of Jersey, United Aircraft. Recent downturns in RS are General Elect., Westinghouse, Sears.

A second excellent preliminary check is RS in the group. I am always skeptical of a strong stock in a weak group. Therefore, if Alcoa (for instance) looks strong but the Aluminum group is showing poor RS, I would be very careful. Whatever is bothering the group will probably work against the stock in due time.

Now to get to the actual individual stocks. I include charts of the three of the thirty new technical charts we are keeping here (see page 6). It is unfortunate that we do not have more history on these, but as time goes by the charts will get bigger and undoubtedly many new facts will be uncovered.

As you can see, these charts deal with the weekly high, low and closing on each stock, plus five technical considerations. These technical gauges are as follows:

(1) The 10-wk moving average advanced three weeks ahead of the price. This is the method used by Dunn & Hargitt (PO Box 101, Lafayette, Ind. 47902). The 10-wk MA plotted three weeks ahead has been carefully tested by Dunn & Hargitt and it has proved to be a very successful method.

(2) On-Balance-Volume, the technical tool invented by my old friend Joe Granville (Box 2614, Orlando, FL). OBV tabulations are arrived at by adding daily volume to a cumulative total if the stock advanced on a given day, subtracting the daily volume if the stock declined that day. Upward and downward zig-zags are particularly significant in OBV analysis, as are new OBV highs or lows. Confirmation or divergence principles are used. These are daily OBV tabulations but plotted once a week.

(3) Relative strength line shows the action of the stock against a broad average, in this case the Standard & Poor's 500.

(4) The odd-lot figures on 100 individual stocks are released very late by the SEC but they are interesting. Chartcraft (Larchmont, NY 10538) takes these figures and tabulates them as 4-week moving averages of the ratio of selling to buying. These are the figures I use. If the odd-lot index is under 100 it indicates that odd-lotters are buying that stock (for instance, a figure of 50 would mean that 50 shares were sold for every 100 purchased). A figure over 100 means that odd-lotters are selling the stock (a figure of 450 would mean that 450 shares were sold for every 100 purchased).

In general, if a stock is rallying and the odd-lot line is rising (increased selling) it is a technical plus. If a stock is declining and the odd-lot line is declining, it means that odd-lotters are accepting the decline as a "bargain" opportunity to buy. This is a technical minus.

(5) On the chart of Texaco we see the monthly short interest plotted in. Not all stocks have a short interest, but where they do, I plot it. In general a rising price accompanied by a rising short interest is a plus (but not always). But it often means that people "think" the stock is "too high" and are shorting it. I find a declining short interest or no short interest is not particularly significant.

All these charts can be graded in a series from zero to five, depending on the following:
One point if the stock is above its 10-wk MA.
One point if the OBV is at a new minor high or has traced an upward zig-zag.
One point if the Relative Strength is at a minor high or in a definite upward trend (this requires interpretation in many cases).
One point if the odd-lot index is above 100 and is moving upward in fairly strong fashion.
One point if the stock possesses a short interest and that short interest is in an upward trend.

I have included three charts for purposes of illustration. Texaco looks fairly strong all around; it is in a strong group, but I have only marked it 3. This is because its OBV line is not clearly bullish and its short interest is down on the latest reading. A rating of 3 is fairly bullish however.

Westinghouse is marked 1 and looks bearish. The group is bearish and the only plus here is the odd-lot index which has moved up since early August. OBV in Westinghouse is poor, and the best I would expect is for the stock to rally to its 10-wk MA.

United Aircraft is a strong stock in a group that is still more neutral than bullish in RS. I grade UA with a strong number 3, as only the odd-lot index is poor here. OBV and RS are excellent, and UA has climbed well above its MA. This overlooked stock could be a leader on any general market rally.

At this time Dow stocks with high ratings are: Amer. Tel., Standard of Jersey, Stand. of Calif., Texaco, and Proc. & Gamble.